Sheryl (Sherry) L. Herauf

PACIFIC TELESIS
Group Washington

August 14, 1995

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, DC 20554

Dear Mr. Caton:

Re: *CC Docket No. 93-193, 1993 Annual Access Tariff Filings*

CC Docket No. 94-65, 1994 Annual Access Tariff Filings

CC Docket No. 93-193, AT&T Communications Tariff F.C.C. Nos. 1 and 2, Transmittal Nos. 5460, 5461, 5462, 5464

CC Docket No. 94-157, Bell Atlantic Telephone Companies Tariff F.C.C. No. 1, Transmittal No. 690

NYNEX Telephone Companies Tariff F C.C. No. 1, Transmittal No. 328

On behalf of Pacific Bell, please find enclosed an original and six copies of its "Direct Case" in the above referenced proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Sherry Herauf

Enclosure

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	CC Docket No. 93-193, Phase I
1993 Annual Access Tariff Filings	
1994 Annual Access Tariff Filings	CC Docket No. 94-65
AT&T Communications Tariff F.C.C. Nos. 1 and 2 Transmittal Nos. 5460, 5461, 5462, 5464	CC Docket No. 93-193, Phase II
Bell Atlantic Telephone Companies Tariff F.C.C. No. 1, Transmittal No. 690	CC Docket No. 94-157
NYNEX Telephone Companies Tariff F.C.C. No. 1, Transmittal No. 328	

DIRECT CASE OF PACIFIC BELL

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Its Attorneys

Date: August 14, 1995

TABLE OF CONTENTS

SUMMARY

In our tariff filings and in this Direct Case, we have fully substantiated our request for exogenous treatment of incremental SFAS-106 costs. The investigation should be concluded with no refund.

We sought recovery only of SFAS-106 costs not already reflected in our rates. Thus, there will be no double-recovery of "pay-as-you-go" OPEB expenses or VEBA trust funding. We also hired NERA to calculate how much the adoption of SFAS-106 would affect the GNP-PI, and subtracted an amount from our request to ensure that no double-recovery would occur due to changes in the GNP-PI or GDP-PI. Finally, we have accounted for the deferred tax benefits associated with the SFAS-106 accrual.

We have also explained in our previous filings and in this Direct Case how SFAS-106 costs were separated and allocated. Our accrual also takes into consideration that some employees will leave the business before being eligible for OPEBs. We have documented the actuarial assumptions that were used to calculate the SFAS-106 accrual. They are all reasonable.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	CC Docket No. 93-193,
	)	Phase I
1993 Annual Access Tariff Filings	)	
	)	
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	)	
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Transmittal Nos. 5460, 5461, 5462, 5464	)	
	)	
Bell Atlantic Telephone Companies	)	CC Docket No. 94-157
Tariff F.C.C. No. 1, Transmittal No. 690	)	
	)	
NYNEX Telephone Companies	)	
Tariff F.C.C. No. 1, Transmittal No. 328	)	
	)	

DIRECT CASE OF PACIFIC BELL

In accordance with the Commission's Order Designating Issues for Investigation,[1] Pacific Bell ("Pacific") hereby respectfully files its Direct Case, demonstrating that the assumptions we used to calculate the exogenous costs of SFAS-106 adoption were just and reasonable, and in the public interest.

The Commission's questions and requests for information are shown below in bold type.

1. General Information on OPEB Costs Claimed

Issue A: Have AT&T and the individual LECs correctly, reasonably and justifiably calculated the gross amount of SFAS-106 costs that may be subject to exogenous treatment under price cap regulation?

[1] *Order Designating Issues for Investigation*, DA 95-1485 (released June 30, 1995) ("Order").

We direct the LECs and AT&T to explain the derivation of the gross amount of incremental costs that is the basis of the exogenous claim including: (1) the date the company implemented SFAS-106; (2) the cost basis of the pay-as-you-go amounts that supported the rates in effect on the initial date that the carrier became subject to price cap regulation; (3) the effect of the price cap formula on that amount up to the date of conversion to SFAS-106; (4) the carrier's actual cash expenditures related to SFAS-106 for each year since the implementation of price caps, but prior to the implementation of SFAS-106 accounting methods; and (5) the treatment of these costs in reports to the Securities and Exchange Commission (SEC) and to shareholders, including specific citations to or excerpted materials from, such reports to indicate the amount of liability each party has projected for OPEBs. (Order, para. 17.)

Pacific's Response:

Please see our Description and Justification for Transmittal No. 1773 to explain how we derived the gross amount of SFAS-106 incremental costs.

(1) We adopted SFAS-106 for interstate accounting purposes effective January 1, 1992.

(2, 3) Prior to January 1, 1991, when we became subject to price cap regulation, the pay-as-you-go claims amount in our interstate rates was $8.7M. Our funded interstate VEBA was $25.3M, for a total interstate cost basis of $34M.

For our exogenous cost request (filed on April 16, 1992, to be effective January 1, 1993), we used 1990 actuals and adjusted them by inflation and productivity factors for 1991 and 1992. The result was $30M of embedded cash basis costs.

The estimated effect of the rate of return change (from 12.0% to 11.25%) effective January 1, 1991, on the $34M, was approximately ($600K), for a cost basis of approximately $33.4M. The

estimated effect of the price cap formula on this amount for the period January 1, 1991 through January 1, 1992, the date we converted to SFAS-106 for interstate accounting purposes, was approximately ($800M). However, our exogenous cost request was based on the incremental difference between SFAS-106 accrual accounting and pay-as-you-go on the effective date of the tariff (January 1, 1993). The estimated effect of the price cap formula for the additional period January 1, 1992 through January 1, 1993 was approximately ($1.2M).

(4) Our 1991 actual cash expenditures (including incremental VEBA expense) were $181M. (See Transmittal No. 1773, Description and Justification, Section VII, Appendix 5, Part A.) The interstate portion was $30M.[2]

(5) We have attached excerpts from reports filed with the Securities and Exchange Commission and our Annual Report to Shareholders for 1991-94 that discuss SFAS-106. (See Appendix 4.)

The LECs and AT&T are directed to: (1) describe each type of benefit being provided that is covered by the SFAS-106 accounting rules; (2) provide, on a year-by-year basis, what the pay-as-you-go amounts would have been had the company not implemented SFAS-106 methods; (3) describe the forms of postretirement benefit accrual accounting, if any, that were utilized before the effective date of price cap regulation; (4) describe the type and provide the level of SFAS-106 type expenses reflected in rates before they were adjusted for any exogenous treatment related to SFAS-106; and (5) provide the level of SFAS-106 expenses that was reflected in the rates in effect on the initial date that the carrier became subject to price cap regulation. (Order, para. 18.)

[2] All interstate amounts were determined by removing non-regulated costs and applying an interstate factor of 17.5%.

Pacific's Response:

(1) We provide medical, dental and group life insurance benefits to retirees, their dependents and their beneficiaries.

(2) If we had not implemented SFAS-106 accounting, our pay-as-you-go claims amounts (not including VEBA expense) for 1992, 1993 and 1994 would have been $124M, $157M and $158M, respectively. On an interstate basis these amounts would have been $21M, $26M, and $27M.

(3) Before the January 1, 1991 effective date of price cap regulation, we used one form of accrual accounting for postretirement group life insurance benefits. We applied the aggregate cost actuarial funding method to determine annual contributions to the Retirement Funding Account. This method determines the difference between the actuarial present value of future benefits liabilities and assets, and spreads it evenly over the remaining future working lives of the current employees.

(4) See p. 2.

(5) None. We adopted SFAS-106 in 1992.

Issue B: Should exogenous claims be permitted for SFAS-106 costs incurred prior to January 1, 1993, the Commission's date for mandatory compliance?

Pacific's Response: This issue does not apply to us.

2. *Regulatory Separations and Allocations*

Issue C: Have AT&T and the individual LECs correctly and reasonably allocated and separated amounts associated with implementation of SFAS-106 in accordance with the Commission's rules and Responsible Accounting Officer (RAO) letters?

The following information shall also be provided in the direct cases: (1) the amount associated with implementation of SFAS-106 for the total company (including telephone operations and non-telephone operations); (2) an explanation of how the carrier arrived at the total company SFAS-106 amounts; (3) the amounts allocated to the telephone operating companies, including the specific Part 32 Accounts used and the amounts allocated to each of those accounts; (4) the method of allocating amounts to the telephone operating companies (head counts, actuarial studies, etc.); (5) the amounts allocated between regulated and non-regulated activities of the telephone company, with a description and justification of the methodology for the allocations; and (6) the allocation of costs to baskets, by year. (Order, para. 20.)

Pacific's Response:

(1) The Pacific Bell amount (which we interpret to mean annual accrued costs) associated with implementation of SFAS-106 (which we interpret to mean 1992, the year in which we adopted SFAS-106 accounting for FCC purposes) was $376M, or $63M on an interstate basis.

(2, 3) We arrived at the Pacific Bell amount by using the actuarial assumptions and methodology required by SFAS-106 and described in Appendix 2 to this Direct Case. (See also our Direct Case, filed in CC Docket No. 92-101 on June 1, 1992.)

We allocated $376M or 96% of the Pacific Telesis amount to Pacific Bell based on proportionate head counts. This amount was flowed through our "benefit matrix" and cleared to final accounts based on how employee salaries were charged to final Part 32 accounts. About 92% of these

costs were charged to various expense accounts and 8% to capital accounts. We cannot readily identify the OPEB amount in each final Part 32 expense and capital account, only the OPEB amounts that went to our benefits clearing account (Account 8701), which were spread pursuant to Part 32 rules to numerous final accounts and capital accounts.

(4) The methodology used to allocate amounts to the telephone operating companies is described in the actuarial report in Appendix 2.

(5) We allocated amounts between our regulated and nonregulated operations based on Part 64 rules and procedures.

(6) In our 1993 exogenous cost request we allocated the incremental SFAS-106 costs to the price cap baskets as shown in Appendix 3.

3. *VEBA Trust Information*

ISSUE D: How should Voluntary Employee Benefit Association trusts or other funding mechanisms for these expenses be treated: (1) if implemented before price caps; (2) if implemented after price caps, but before the change required by SFAS-106; and (3) if implemented after the change in accounting required by SFAS-106?

Pacific's Response:

(1) The Commission explicitly allowed expenses for pre-price cap VEBA trusts, like ours, in its orders on pre-price caps annual access tariffs. These expenses should remain in our rates. So

long as these expenses are subtracted from requests for exogenous treatment of SFAS-106 costs (as we have done), there will be no double recovery.

(2) This issue does not apply to us.

(3) For accounting purposes, VEBA funding that occurred after the adoption of SFAS-106 accounting by the Commission is no longer recognized as an expense, but a reduction in SFAS-106 liability. For ratemaking purposes, post-price cap VEBA funding is an endogenous business decision that is irrelevant to recovery of exogenous SFAS-106 costs.

ISSUE E: Should exogenous treatment for SFAS-106 amounts be limited to costs that are funded?

Pacific's Response:

No, for at least two reasons. For the 1993-94 period at issue in this investigation, such a requirement would effectively add another prong to the test for recovery of exogenous costs. Our entitlement to recovery of incremental OPEB expenses arises from the adoption of SFAS 106 accounting by the Commission. Our obligation to accrue and pay OPEBs to retirees is not triggered by or even affected by decisions to fund tax-advantaged VEBA trusts. VEBA trusts and pension trusts are not analogous. VEBA trusts, unlike pension trusts, are optional. Moreover, our obligations to pay OPEBs are not limited by what has been funded in VEBAs.

Second, since RAO 20 requires a ratebase reduction for unfunded OPEB costs, full recovery of OPEB costs should be permitted.

The following information shall be provided by companies that have Voluntary Employee Benefit Association (VEBA) trusts or other funding mechanisms for SFAS-106 expenses that were established prior to the adoption of SFAS-106: (1) describe any VEBA trust or other funding mechanisms for the expenses that were established prior to the adoption of SFAS-106; (2) provide the amounts, placed in these funds for each year since they were implemented, including the 1990-91 tariff year for LECs and the 1989-90 tariff year for AT&T; (3) describe and provide the amounts in the trust that were for ongoing OPEBs and those that were for TBO; (4) describe the assumptions made when the funds were set up, including, but not limited to, the time value of money, expected long-term rate of return on plan assets, future compensation levels, and retirement age factors affecting the amount and timing of future benefits, (5) state the purpose of the VEBA funds and describe what SFAS-106 benefits packages are covered by each VEBA fund; and (6) describe the restrictions, if any, that prevent these VEBA funds from being used for other than SFAS-106 benefits. (Order, para. 21 (footnotes omitted).)

Pacific's Response:

(1) Before adopting SFAS-106 (i.e., before January 1, 1992), we established a bargained VEBA trust to fund postretirement medical and dental costs for employees covered by collective bargaining agreements. Group life insurance benefits (for both collectively bargained and noncollectively bargained employees) were also funded in a VEBA trust. Pacific Telesis Group established a postretirement health care trust on December 29, 1989 as a collectively bargained VEBA under Section 501(c)(9) of the Internal Revenue Code.

(2) Appendix 3 shows our contributions to the VEBA trusts since they were implemented.

(3) We do not distinguish between amounts placed in the trust that are applicable to ongoing OPEBs and those applicable to the TBO.

(4) The actuarial assumptions chosen when these funds were set up are consistent with those summarized in the actuarial report included in Appendix 2. This report shows the time value of money, expected long-term rate of return on plan assets, future compensation levels, retirement age factors affecting the amount and timing of future benefits, and numerous other assumptions.

(5) The purpose of the VEBA trusts is to prefund a portion of postretirement benefits.

(6) The funds invested in these trusts are held for the exclusive purpose of providing postretirement benefits under health care plans that provide medical and dental benefits. The trust provides that, except as permitted by law and the return of contributions made to the trust by reason of a mistake of fact, at no time shall any part of the trust be used for, or diverted to, any purposes other than the provision of postretirement medical and dental benefits and for defraying the reasonable expenses of the trust.

4. *Vesting of OPEB Interests*

ISSUE F: Should exogenous treatment be given only for amounts associated with employee interests that have vested?

We direct the LECs and AT&T to provide documentation showing when the employees' interests in the OPEBs vest. Also, companies must explain how they determine when an employee's interest vests in the OPEBs. (Order, para. 22.)

Pacific's Response:

Our SFAS-106 exogenous request takes into consideration that some employees will leave the business prior to being eligible for OPEBs. No OPEBs cost has been requested for these individuals.

Full eligibility for benefits is achieved when employees meet certain age, service, or a combination of age and service requirements. Although OPEB benefits do not technically "vest," SFAS-106 calculations require employers to recognize that OPEB benefits will be paid only to those who meet benefit eligibility requirements. Our employees are eligible for OPEBs only when they qualify for a service or disability pension retirement.

5. *Treatment of Deferred Tax Benefits*

ISSUE G: How should the deferred tax benefit applicable to OPEBs be treated for purposes of exogenous adjustments?

AT&T and the LECs are directed to describe on a year-by-year basis any exogenous adjustments made to reflect any deferred tax benefit associated with their OPEB accrual amounts. Companies are also directed to provide an explanation if there are no such adjustments. (Order, para. 23.)

Pacific's Response:

The deferred tax benefit should be added to the ratebase pursuant to RAO 20.

We have already accounted for deferred tax benefits in our request for exogenous treatment. See our Direct Case in CC Docket No. 92-101, Appendix 2, Workpaper 5.3.

6. *Supporting Studies and Models*

We require each company to include in its direct case all studies upon which the company seeks to rely in its demonstration that these accounting changes should receive an exogenous cost adjustment. This includes studies demonstrating that the change is not reflected in the current price cap formulas, factors for inflation, productivity, allowed exogenous changes, the rates in effect on the initial date that the carrier became subject to price cap regulation, or, for the LECs, the sharing and low-end formula adjustment mechanisms. (Order, para. 24.)

Pacific's Response:

We have attached the NERA study that demonstrates our requested OPEB exogenous adjustment is not included in the price cap formula (Appendix 1).

Parties and commenters relying on a macroeconomic model shall fully describe and document the mode, including the method of estimation, parameter estimates, and summary statistics. These same data should be submitted for any alternate functional forms that were modeled, including the data used to estimate the model, the data used in making forecasts from the model, and the results of any sensitivity analyses performed to determine the effect of using different assumptions. (Order, para. 25.)

Pacific's Response:

We relied on the NERA model, which is documented in Appendix 1.

AT&T and the LECs shall provide a complete copy of all actuarial reports and studies used to determine SFAS-106 amounts and should provide descriptions and justifications of the actuarial assumptions, and the assumption unique to postretirement health care benefits, made in computing the SFAS-106 expenses. These assumptions should include, but are not limited to, the time value of money, expected rate of return on plan assets, participation rates, retirement age, per capita claims cost by age, health care cost trend rates, medical reimbursement rates, salary progression (if a company has a pay-related plan), and the probability of payment (turnover, dependency status, mortality, etc.). Parties and commenters should also discuss what assumptions, if any, were made about other future events such as capping or elimination of benefits, or the possible advent of national health insurance. (Order, para. 26.)

Pacific's Response:

Our actuarial report is included in Appendix 2. That report outlines the projected 1993 OPEB expense for the Pacific Telesis Group. It also discloses the actuarial assumptions, plan provisions, pertinent data and financial results.

The calculation methodology and the actuarial assumptions were chosen in accordance with generally accepted accounting and actuarial principles. Specifically, we relied upon guidelines outlined in either draft or final form contained in Statement of Accounting Standard No. 106, Actuarial Compliance Guideline No. 3 and Actuarial Standard of Practice No. 6. A basic tenet of these guidelines is that the actuary should select the best estimate for each individual assumption in performing a valuation.

All assumptions, including the possibilities of capping or eliminating benefits and the creation of national health insurance, were included in the valuation either explicitly or implicitly.

We also direct AT&T and the LECs to submit all options provided by actuaries from which information was selected to derive SFAS-106 amounts including, but not limited to: the ranges of data on the age of the workforce; the ages at which employees will retire; mortality rates; the gross eligible charge table by age; and the length of service of retirees. For comparison purposes, carriers should also provide the actuarial assumptions and data used for SFAS-112 computations. Carriers should provide information on whether they took into account the possibility of future downsizing of the workplace. Carriers should provide information on what adjustments they have made to their SFAS-106 amounts for downsizing in the workforce that have occurred since the adoption of SFAS-106. Carriers should give full details of these adjustments. (Order, para. 27 (footnote omitted).

Pacific's Response:

To the extent applicable, the actuarial assumptions from the pension plan valuations (Statement of Financial Accounting Standards No. 87) were also used to value OPEBs. Then our actuary selected the assumptions that are unique to OPEBs in order to determine the expense.

The actuarial assumptions and data we used for SFAS-112 (long-term disability expense) are consistent with those we used in SFAS-106. See Appendix 6.

In the actuarial report in Appendix 2, we reflected downsizing due to either termination or retirement based on the current business plan. Each successive valuation considers updates made to the business plan as new information becomes available. We anticipate future SFAS-106 expenses to remain somewhat level as downsizing continues to occur through early retirements, which produce actuarial losses, and terminations without OPEBs, which produce actuarial gains.

Further, since part of the growth in Gross Domestic Product Price Index (GDP-PI) presumably occurs due to growth in medical costs, we seek information on what adjustment, if any, should be made in the exogenous adjustment to avoid any double-counting. If an adjustment has been made, parties and commenters shall document how the adjustment was computed. Moreover, parties and commenters should describe and quantify any wage changes that will be reflected in the GDP-PI that are expected to occur as a result of the introduction of SFAS-106. In particular, parties and commenters should discuss what adjustment, if any, should be reflected in the exogenous adjustment for this change. (Order, para. 28 (footnote omitted).

Pacific's Response:

The NERA study calculates a factor that eliminates any potential double count. NERA shows that firms outside the "cost-plus" sector have already reflected the economic costs of OPEBs (including future inflation in medical costs) into their pricing decisions. For this large share of the U.S. economy, the increase in accounting costs due to the adoption of SFAS-106 will not affect future wages or prices. Firms in the "cost-plus" sector may be expected to increase prices due to SFAS-106 adoption. But by excluding a proportion of our SFAS-106 costs that corresponds to the proportion of GNP/GDP that these "cost-plus" firms represent, we have assured that any GDP-PI increases due to SFAS-106 will not be reflected in our prices. See Appendix 1, pp. 25 et seq.

The change from GNP to GDP in 1995 is legally irrelevant to the recovery of exogenous costs incurred in 1993 and 1994. In any event, the difference between the two is miniscule. The U.S. Department of Commerce Bureau of Economic Analysis' (the "BEA's") Survey of Current Business for August 1994 shows that the cumulative difference between GNP-PI and GDP-PI between 1980 and 1993 (inclusive) was less than one-tenth of a percent.

7. *Miscellaneous Supporting Information*

Each carrier shall provide information on its average total compensation per employee and the amount of this total compensation represented by OPEBs. We ask parties and commenters to provide similar data for the economy as a whole for comparison. This comparison is consistent with the Commission's price cap formula, which includes a productivity factor. By using this factor, the price cap index takes into account the productivity of the carrier regulated under price caps as compared to the economy as a whole. Historically, the telecommunications industry has had a higher level of productivity than the economy as a whole. (Order, para. 29 (footnote omitted).)

Pacific's Response:

In 1993, the year in which we first sought exogenous cost recovery of OPEBs, our average total compensation per employee was $57,154. Of this amount, $7,213 or 12.62% represents OPEBs. According to the BEA, in 1993, compensation for the U.S. economy per employee was $34,142, including benefits.

The Court of Appeals' decision makes clear that any ability the price cap LECs have to reduce the level of their OPEB expenses is irrelevant to the recoverability of exogenous costs such as the SFAS-106 accrual. To assure that any difference between the level of OPEBs paid by "cost-plus" firms and other firms is not reflected in future GDP-PI changes, NERA has conservatively assumed that all "cost-plus" firms will increase prices because of SFAS-106 to the same degree that we have requested. See NERA, p. 30.

Because the accruals for OPEBs generally represent non-cash expenses that may never be paid, we direct parties to describe the provisions they have made, if any, to return to ratepayers the over-accrual, if any, of the non-cash expenses if exogenous treatment is given for these amounts. Parties should describe any plans they have to return such monies to customers through voluntary PCI reductions or other means. Parties shall also describe how they recognize these gains from such over-accruals on their books of account. (Order, para. 30.)

Pacific's Response:

The Commission said when it adopted price cap regulation that our rates at that time (which recovered our expenses at that time) were the best possible starting point for price cap rates. Once included in our rates as an exogenous cost increase, any changes to OPEB costs, like any

changes to any of our costs, are treated endogenously. If reductions to our expenses do not match the productivity factor reduction (now an aggressive 5.3% for us), our earnings will be reduced. If expense reductions exceed the productivity factor reduction, we are rewarded with higher earnings. "True-ups" of the expenses on which our price cap rates are based, to recapture any expense reductions, are completely foreign to price cap regulation. If the Commission wishes to treat exogenous costs differently from other costs once included in our rates, it would have to adopt a new price cap rule -- though it seems to us that such a rule, by applying discriminatory regulatory treatment to different types of costs, would be unworkable and would be inconsistent with price cap regulation. In reality, the extent of below-cap pricing before the recent huge Commission-mandated reduction in 1995 annual access rates demonstrates that competitive factors have exerted downward pressure on our prices over and above price cap formula reductions.

The SFAS-106 accrual is self-correcting in that any change in the OPEBs liability will be reflected in the ongoing accrual amount.

The accrual calculations used by the companies to develop their claims for exogenous treatment for SFAS-106 amounts are, in part, based on the OPEBs provided pursuant to contracts between the companies and their employees. These contracts are currently being renegotiated. The OPEB benefits represent a significant issue in these negotiations. Any change in OPEBs will affect future accrued amounts and will be useful to compare prior calculated accruals to the new OPEB contracts to aid in determining whether the former calculations were reasonable. In particular, we are interested in determining whether the underlying actuarial assumptions have changed. Therefore, on an ongoing basis, parties shall document any and all changes made in OPEBs offerings to employees. Any new contracts with employees and their representative unions shall be submitted as they are negotiated. (Order, para. 31.)

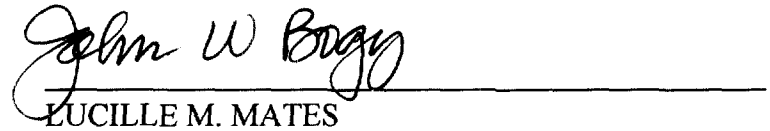
Pacific's Response:

Our new labor contracts have not yet been ratified. However, there is expected to be no material change to OPEBs.

8. *Conclusion*

We have fully substantiated our request for exogenous treatment of incremental SFAS-106 costs. This investigation should be concluded with no refund.

PACIFIC BELL



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Its Attorneys

Date: August 14, 1995

Appendix 1

NERA Report

THE TREATMENT OF FAS 106 ACCOUNTING CHANGES UNDER FCC PRICE CAP REGULATION

Prepared for

Pacific Bell

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William E. Taylor and Timothy J. Tardiff
Study Directors

April 15, 1992

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TABLE OF CONTENTS

THE TREATMENT OF FAS 106 ACCOUNTING CHANGES UNDER FCC PRICE CAP REGULATION

I. INTRODUCTION AND SUMMARY

Under the theory of price cap regulation, changes in costs that are beyond the control of the firm (so-called "exogenous cost changes") are accorded special treatment. In general, changes in a regulated firm's costs should lead to changes in its prices because economic efficiency is enhanced when prices are kept close to (incremental) costs. However, the direct pass-through of all cost changes as price changes--as is done under traditional rate of return regulation--removes incentives the firm might have to control cost changes in the first place. Thus, price cap regulation permits only exogenous cost changes to affect the price cap. Incentives are preserved, and price changes follow cost changes to the greatest extent possible.

Pacific Bell is required to adopt a particular set of accounting changes--FAS 106 (Employers' Accounting For Postretirement Benefits Other Than Pensions)--no later than 1993. These changes were recently enacted by the Financial Accounting Standards Board (FASB) and have been adopted by the FCC.[1] Pacific is seeking recovery of the associated cost increase through a one-time Z-adjustment to its price cap to reflect (i) the amortization over 15 years of the historical liability for these benefits, and (ii) the shift from cash to accrual accounting for these benefits on a going-forward basis. Future changes in postretirement expenses would have no future effect on

[1]Federal Communications Commission, "Notification of Intent to Adopt Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions," AAD 91-80, December 1991.